DECISION

THE COMPTROLLER GENERAL
OF THE UNITED STATES
WASHINGTON, D.C. 20548

FILE: B-212158 **DATE:** April 25, 1984

MATTER OF: Wheeler Brothers, Inc.

DIGEST:

GAO recommends that the agency omit from a spare parts solicitation a clause providing that a contractor's percentage profit on substitute parts must be the same as that for name brand parts; the clause was intended to benefit the government by preventing contractors from reaping excessive profits on substitute parts, but in fact operates to the government's overall detriment by preventing offerors from factoring lower cost substitute parts into their proposed prices, and by creating a competitive advantage for the name brand manufacturer and its distributors.

Wheeler Brothers, Inc. protests the award of any contract under request for proposals (RFP) No. DLA700-83-R-0281, issued by the Defense Logistics Agency (DLA) for automotive and truck parts. Wheeler contends that an RFP clause limiting an offeror's markup over its cost of the parts unduly restricts competition and prevents the government from receiving the lowest possible prices for parts. We sustain the protest.

The RFP contemplated the award of a 1-year (plus two 1-year options) automated indefinite delivery type contract for supplying auto and truck replacement parts manufactured by or for Chrysler Corporation. Offers were to be expressed as percentage discounts off the Chrysler Corporation Master Parts Price List, to be applied to all parts ordered under the contract. The firm offering the largest discount would, if otherwise eligible, receive the award. Although DLA's requirement was expressed in terms of Chrysler parts, the agency recognized that its needs could be met by non-Chrysler, substitute parts if those parts were interchangeable with Chrysler parts. The RFP thus provided that substitute parts could be supplied if listed in interchange catalogs

specified in the contractors' proposals and approved by the contracting officer at the time of award.[1]

While realizing that acceptable substitute parts would meet its needs, DLA also was aware that substitute parts commonly are significantly less costly than name brand parts and believed that a contractor could realize excessive profits by offering a discount based on Chrysler parts and then furnishing cheaper acceptable substitute parts wherever possible under the contract. DLA therefore inserted a clause in the RFP to limit the contractor's markup on substitute parts to the same percentage markup the contractor would receive for supplying Chrysler parts. This clause reads as follow:

> "Substitute parts . . . will be priced at the contract price for the part ordered or at the price paid by the contractor for the substitute part increased by the same percentage markup that would have resulted from delivery of the part ordered, whichever is lower . . . ."

Wheeler asserts that the clause prevents it and other offerors from proposing the greatest discount otherwise permissible under the RFP. According to Wheeler, the clause prevents it from offering the lowest possible price to the government because it doesn't permit it to propose a discount reflecting a very low markup (or even a loss) on Chrysler parts that it would compensate for by furnishing higher-markup substitute items, all at a lower overall price to the government.

---

[1]We have approved DLA's use of this name brand part-based discount pricing procedure in lieu of having offerors propose individual prices for each part (which would enable offerors to propose specific substitute parts in their proposals), because of the vast number of parts covered by this type of contract. See McCotter Motors, Inc., B-188761, et seq., January 12, 1978, 78-1 CPD 29. Requiring individual prices would render the evaluation administratively burdensome and, since it is not possible to predict in advance which parts would be ordered, would lead to other evaluation problems.

The following illustration is instructive. An offeror desiring a 5 percent profit on the entire contract could propose a discount reflecting zero markup on Chrysler parts with the intention of furnishing substitute parts, that cost considerably less, for one-half of the requirement at a 10 percent profit. Under the clause, however, a firm using this pricing strategy would receive zero profit for the entire contract because the clause limits the markup on substitute parts to the markup on Chrysler parts. Without the clause, an offeror could use this strategy and, as a result, propose an overall greater discount off the Chrysler price list.

Wheeler further argues that the clause creates an unfair advantage for Chrysler and its distributors by effectively providing that the award will be made to the offeror proposing the best price for Chrysler parts alone, despite the fact that substitute parts also are acceptable. Wheeler points out that since only Chrysler and its distributors get Chrysler parts at the lowest cost, they are in a position to propose the best price. Wheeler also considers the clause improper because, in preventing it from proposing the lowest possible price, the clause obviously prevents the government from meeting its minimum needs at the lowest cost.

DLA does not disagree that the clause operates to prevent firms from proposing discounts based on Wheeler's strategy. It takes the position, however, that only relatively few substitute parts could be used under the contract, and that the clause therefore could have no more than a negligible impact on the proposed discounts. DLA evidently believes its interest in preventing contractors from reaping exhorbitant profits under the contract, and thereby assuring that it pays reasonable prices for substitute parts, overshadows the minimal cost savings which might be realized by eliminating the clause.

We endorse practical agency efforts to assure that contractor profits and overall contract prices are reasonable. On the other hand, we believe it is contrary to the government's best interest to attempt to control contractor profit on specific items under a contract with a solicitation provision which likely will have a net effect of increasing the government's total contract cost. In other words, the price reasonableness of portions of a contract should not be elevated above the government's primary interest in fulfilling its minimum needs at the lowest possible cost. We find that the clause violates this principle.

Although the clause clearly is an effective means of preventing the ultimate contractor from earning exhorbitant profits on substitute parts, any seeming benefit to the government in terms of cost savings is illusory. The clause, by effectively eliminating substitute parts pricing from the competition (i.e., since the award is based on Chrysler part prices), assures that offerors will not propose discounts which reflect the lower cost of substitute parts and, thus, that the government will not receive the benefit of those lower costs. Further, while the ultimate contractor will be free to furnish acceptable substitute parts, the clause operates as a disincentive for the contractor to do so, since it applies the same markup percentage to both Chrysler and substitute parts and thus assures that the contractor will receive a larger dollar markup for the more expensive name brand parts. Thus, while the clause will assure that the contractor does not reap excessive profits from furnishing substitute parts, it will not reduce the total contract cost, and likely will result in higher offered prices (i.e., lower discounts).[2]

We also agree with Wheeler that, by operating to focus the competition on Chrysler part pricing, the clause creates a competitive advantage for Chrysler (and its distributors) which could be expected to reduce competition to some degree and possibly lead to higher prices for Chrysler parts.

The subordination of the total contract cost to profit--the net effect of the clause--runs counter to procurement policy reflected in both applicable regulations and decisions by our Office. Defense Acquisition Regulation § 3-806(b) states, in pertinent part, that:

---

[2]DLA tentatively has agreed to amend the clause to provide for the same dollar amount markup for Chrysler and substitute parts in lieu of the same markup percentage. While this change would appear to eliminate the incentive to furnish the most expensive parts, it would not go the further step of enabling offerors to propose the lowest possible discounts reflecting a mix of Chrysler and substitute parts. Further, Wheeler indicates that there would remain some incentive to furnish Chrysler parts since they are more easily obtainable.

> ". . . While the public interest requires that excessive profits be avoided, the contracting officer should not become so preoccupied with elements of a contractor's estimate of cost and profit that the most important consideration, the total price itself, is distorted or diminished in its significance . . ."

We have specificially recognized the applicability of this principle to spare parts procurements. See Wheeler Brothers, Inc., 54 Comp. Gen. 1050 (1975), 75-1 CPD 356.

In a similar vein, we have held in the area of unbalanced bidding that even where a portion of a bid is overstated in comparison to the work it covers, the bid need not be rejected as materially unbalanced so long as it represents the lowest overall cost for the entire contract. See, e.g., Adam II, Limited, B-209194, July 12, 1983, 83-2 CPD 102.

DLA's defense of the clause assumes that the threat of competition alone will not suffice to force offerors to limit their profit on substitute parts. We find nothing inherent in automotive parts procurements (and DLA has brought nothing to our attention), however, which suggests that the competitive process will not operate as efficiently in this area as it does in others. Eliminating the clause thus should result in encouraging all offerors to propose prices based on furnishing the government the lowest-priced acceptable part in all instances.[3]

We find unpersuasive DLA's argument that only a relative few substitute parts could be furnished under this contract and that the impact of the clause on the proposed discounts thus would be negligible. While it is not clear from the record how many substitute parts would be acceptable, it is clear that a number of these

---

[3]We are aware that agencies may in fact prefer to be furnished name brand rather than substitute parts. Where, as here, the solicitation indicates a determination that substitute parts in interchange catalogs meet the agency's minimum needs, however, offerors should be encouraged to propose prices based on furnishing these parts.

parts would be acceptable, and we are persuaded that this number could be rather substantial. Wheeler states, without argument from DLA, that literally thousands of parts of different manufacturers are included in the government's own master cross reference list. It believes a significant percentage of the government's requirement could be satisfied with substitute parts. DLA has not submitted any evidence as to the number of substitute parts furnished under prior contracts, despite being in the best position to do so. Furthermore, DLA obviously considers the potential number of substitute parts significant enough to warrant a clause controlling the markup on those parts.

We conclude that the limitation clause is counterproductive, its negative effects clearly outweighing any beneficial purpose it may serve, and that it thus does not serve the government's best interests. We are recommending that DLA cancel the solicitation and recompete this requirement using a solicitation without a markup limitation clause tying the contractor's markup for substitute parts to its markup for Chrysler parts.

The protest is sustained.

This decision contains a recommendation that corrective action be taken. Therefore, we are furnishing copies to the Senate Committees on Governmental Affairs and Appropriations, and the House Committees on Government Operations and Appropriations in accordance with section 236 of the Legislative Reorganization Act of 1970, 31 U.S.C. § 720 (1982), which requires the submission of written statements by the agency to the Committees concerning the action taken with respect to our recommendation.

Milton J. Socolar

Acting Comptroller General
of the United States